IN THE

UNITED STATES COURT OF APPEALS

For The Ninth Circuit

No. 15985

ROBLEY H. EVANS and JULIA M. EVANS,
husband and wife,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Reply Brief for Petitioners

ROSWELL MAGILL
15 Broad Street
New York, New York
LYLE L. IVERSEN
800 Hoge Building
Seattle, Washington
EDGAR BERNHARD
33 North LaSalle Street
Chicago, Illinois
DONALD J. YELLON
33 North LaSalle Street
Chicago, Illinois
JOHN C. KLETT, JR.
15 Broad Street
New York, New York
Attorneys for Petitioners

Of Counsel:
CRAVATH, SWAINE & MOORE
15 Broad Street
New York, New York
D'ANCONA, PFLAUM, WYATT & RISKIND
33 North LaSalle Street
Chicago, Illinois

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In an attempt to justify and support the Tax Court's opinion below, the Commissioner (1) introduces references to the doctrine of obsolescence, although no property involved in this case is obsolete; (2) seeks to apply to 1950-1951, the years in issue, definitions of the terms "useful life" and "salvage value" which appeared for the first time in the Regulations promulgated in 1956 under the Internal Revenue Code of 1954; and (3) conversely, stresses and strains the meaning of the term "in the business" found in the Regulations and in some cases prior to 1942.

The Commissioner advances the first two theories mentioned above merely to rationalize his position, based upon his application of the third.

Prior to the promulgation in June, 1956, of Regulations under Section 167 of the 1954 Code (wherein the definitions of "useful life" and "salvage value" are designed to limit the application of the new alternative methods of computing depreciation), the terms "useful life" and "salvage value" were consistently interpreted by the courts, the Commissioner and taxpayers to mean the physical life of the asset and junk or scrap value at the end of such life, respectively. Indeed, up to that time, disputes between the Commissioner and taxpayers invariably arose because the Commissioner was attempting to impose a longer period of useful life (one measured by the physical life of the assets), than the taxpayer was willing to use.

It is significant that the Commissioner has not cited a single case or ruling under the 1939 Code or prior Revenue Acts in which he contended for (much less established) the position which he now takes both in this case and in the Regulations under the 1954 Code, that useful life means the period an asset is used by a taxpayer in his business. The explanation for this lack of citation is obvious—there is none. Heretofore, the Commissioner maintained that useful life meant the physical or inherent functional life of the property. The petitioner herein adopted what was then the Commissioner's position when he prepared his returns for 1950 and 1951.

(1) The Tax Court's definitions of useful life and salvage value are conclusions of law which are fully reviewable by this Court.

The Commissioner's brief states (page 3) that the findings of the Tax Court must be accepted as the facts of the case unless shown to be clearly erroneous, and then proceeds to enumerate these findings. The last two findings enumerated (page 6) are those assigning specific figures for the useful lives and salvage values of petitioner's automobiles.

What meanings should be ascribed to the terms "useful life" and "salvage value" are clearly questions of law, whatever the facts may be as to the time the automobiles will last, or how much they will be worth as junk. We submit that there is no legal foundation for the Commissioner's contention that this Court cannot review the interpretation the Tax Court placed on these two terms.

On this question, the Supreme Court of the United States said, in *Helvering* v. *Tex-Penn Oil Co.,* 300 U.S. 481 (1937), at page 491:

> ". . . In addition to and presumably upon the basis of these findings, the board made its 'ultimate finding.' And upon that determination it ruled that the transaction was not within the non-recognition provisions of §202(b). The ultimate finding is a conclusion of law or at least a determination of a mixed question of law and fact. It is to be distinguished from the findings of primary, evidentiary or circumstantial facts. It is subject to judicial review and, on such review, the court may substitute its judgment for that of the board."

See also: *Bogardus* v. *Commissioner of Internal Revenue,* 302 U.S. 34, 39 (1937).

The Court of Appeals for the Third Circuit pointed out in *Philber Equipment Corporation* v. *Commissioner of Internal Revenue,* 237 F. 2d 129 (C.A. 3rd, 1956), with respect to the reviewability of the Tax Court's "ultimate finding of fact":

> ". . . since such finding is but a legal inference from other facts it is subject to review free of the restraining impact of the so-called 'clearly erroneous' rule applicable to ordinary findings of fact by the trial court. . . ." (237 F. 2d, at 131).

See also: *Hypotheek Land Co.* v. *Commissioner of Internal Revenue,* 200 F. 2d 390 (C.A. 9th, 1952), at page 392; and *Casale* v. *Commissioner of Internal Revenue,* 247 F. 2d 440 (C.A. 2nd, 1957), at page 443.

There is no "clearly erroneous" rule with respect to questions of ultimate fact or matters involving conclusions of law. Upon such matters and questions a reviewing court may substitute its judgment for that of the Tax Court.

The Tax Court's unreasoned acceptance of new definitions of useful life and salvage value involves a decision concerning the correct definition of legal terms used in the governing tax regulations and is therefore fully reviewable by this Court.

(2) There is no obsolescence question in this case.

It is understandable that the Commissioner in his brief (see, particularly, page 13) treads lightly and inconclusively on an alleged obsolescence factor in this case. Regulations 111, governing the taxable years here in issue, provided in Sec. 29.23(l)-6, in part:

> "With respect to physical property the whole or any portion of which is clearly shown by the taxpayer as being affected by economic conditions *that will result in its being abandoned* at a future date prior to the end of its normal useful life, so that depreciation deductions alone are insufficient to return the cost or other basis at the end of its economic term of usefulness, a reasonable deduction for obsolescence, *in addition to depreciation,* may be allowed in accordance with the facts obtaining with respect to each item of property concerning which a claim for obsolescence is made." (Emphasis added.)

The allowance for obsolescence authorized by the statute has always been designed to give taxpayers an additional deduction, over and above the normal depreciation. The Commissioner does not suggest the allowance of an additional deduction in connection with his claim (Brief, pages 11-12) that "Because of the nature of taxpayer's business, it is clear that obsolescence, rather than physical exhaustion, was the principal factor in the depreciation of most of his automobiles." Indeed, the Commissioner's suggested application of the obsolescence doctrine in this case concludes with the anomalous result of petitioner's being allowed a deduction substantially less than the amount he would ordinarily be entitled to under a straight-line 25% depreciation rate.

The foundation for obsolescence, according to the Regulations, is the expected early "abandonment" of the property. The term "abandoned", as used in those regulations, has repeatedly been held not to include property which was to be sold at a time when it had substantial value and was to be used for other purposes, instead of being scrapped. In *The Olean Times-Herald Corporation,* 37 BTA 922 (1938), the Board of Tax Appeals denied the taxpayer an allowance for obsolescence of a printing plant and building which it no longer used, noting that the building could be put to other use (just as petitioner's cars could be put to other uses), and that in fact the building was not abandoned in 1933, but rather it was put up for sale in that year and sold in 1935.

Similarly, in *Southeastern Building Corporation,* 3 TC 381 (1944), aff'd 148 F. 2d 879 (C.C.A. 5th, 1945), cert. den. 326 U.S. 740, the Tax Court held that a deduction for obsolescence was not allowable for taxpayer's warehouse where "Though the special use [of the warehouse] will terminate at a certain date, *the property is neither to be scrapped nor abandoned, and will continue to have economic usefulness, though in a different use.*" (3 TC, at 388; emphasis added.)

In the case at bar, there was no abandonment. The assets undeniably continued to have economic usefulness.

Recently, the Court of Appeals for the Second Circuit affirmed the Tax Court's opinion in *Giles E. Bullock, et al.*, 26 TC 276 (1956), aff'd 58-1 USTC Para. 9418 (April 7, 1958), in which the Tax Court rejected taxpayer's contention that his depreciable equipment was obsolete. It was the Court's view that assets which are shown to have substantial economic and business value are not obsolete within the meaning of Section 23(l) of the 1939 Code, stating that there was no evidence in the record that the asset involved was "being affected by economic conditions that [would] result in its being abandoned at a future date prior to the end of its normal useful life." (26 TC, at 281.)

During the years in issue, the automobiles of petitioner herein were sold for substantial amounts. On the facts of this case, there is no issue of obsolescence, and the only question is the definition of the terms "useful life" and "salvage value" in the context of the applicable statutory words "exhaustion, wear and tear."

Indeed, it is on the basis of this fact of substantial value that the Commissioner has sought to divert the attention of this Court. After stating the proposition that the depreciation allowance must be reasonable, the Commissioner's brief states, at page 10, that "Taxpayer is not entitled to convert ordinary income into capital gain through the depreciation deduction"—the implication apparently being that the production of a capital gain after the taking of depreciation is unreasonable. This is then called a "device" (page 11) or a "scheme" (page 8).

The facts are that during the taxable years in question, 1950 and 1951, the price of used cars went up abnormally because of the Korean War and anticipated rationing (R.

71), causing an unusually small decline in the market value of the cars as compared with the depreciation taken on them. It can be seen that during such periods of rising used car prices it is inevitable that depreciation will exceed the shrinkage in market value. The necessary corollary of this unusual market condition is the realization of capital gains upon asset disposal. Conversely, when the used car market declines, the market value shrinkage may well exceed depreciation and losses will be produced. Whatever the proper interpretation of salvage value may be, it surely may not, we submit, be an inflated selling price imposed on a taxpayer by the Commissioner's hindsight adjustment.

(3) The Commissioner's historical survey of the phrase "in the business" as it appears in the regulations does not sustain his position.

Throughout his brief, the Commissioner seeks to attach a peculiar significance to the phrase "useful life of the property in the business." In addition to citing the depreciation regulations as they appeared from 1918 to 1942, the Commissioner cites such judicial decisions as *United States* v. *Ludey,* 274 U.S. 295 (1927), also cited by the Tax Court below. From his discussion accompanying these citations we understand the Commissioner to be saying that from 1918 to 1942, the regulations with respect to depreciation and the courts have defined the term "useful life" to be the period during which an asset is used by the taxpayer "in the business". On the basis of the Commissioner's own analysis of the reasons and need for changing the regulations in 1942 and the decisions of the courts during the period 1918-1942, discussed in petitioner's opening brief (pages 17 to 21), we submit that the Commissioner's position is untenable.

If the term "useful life of the property in the business" were intended to define the period of useful life for depreciation purposes, as now contended by the Commissioner, its deletion in 1942 would have been both unnecessary and inappropriate. As the Commissioner correctly points out at page 23 of his brief, the regulations were changed in order to "give the Regulations broader application, *i.e.*, to depreciation 'of property held for the production of income.' " In other words, the term "in the business" as it appeared in the court decisions and the regulations from 1918 to 1942, had the sole purpose of defining the nature or type of assets which could be depreciated by a taxpayer, that is, property "devoted to business" or, simply, "business property". It is clear that the term did not mean and never was intended to be a limitation on the period during which business assets could be depreciated.

(4) The Commissioner erroneously seeks to apply to this case his new definitions contained in the 1956 regulations issued under the 1954 Code.

It is apparent that the Commissioner's theory of this case is that it is governed by his new depreciation regulations—issued on June 11, 1956 under the 1954 Code enacted on August 16, 1954.

Not only does he quote them at length in Appendix B to his brief, but the following comparison shows that the Commissioner, in his brief, has liberally adopted language from the 1956 regulations which is nowhere to be found in the regulations applicable to this proceeding (Regulations 111) or in any of the other 85 authorities cited in his brief:

From Commissioner's brief herein	From the 1956 regulations (*not* applicable to the taxable years 1950 and 1951)	From the app cable regulatio —111
Page 7: " . . . [T]he Commissioner contends that, for the purpose of computing a reasonable depreciation allowance pursuant to Section 23(1), *the estimated useful life over which an asset is to be depreciated by a taxpayer is not necessarily the useful life inherent in the asset, and in the present case is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business.*" (Emphasis added.) [This language is repeated in substantially identical manner at page 18 of the Commissioner's brief.]	Reg. Sec. 1.167(a)-1(b) [in part]: "For the purpose of section 167 *the estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income.*" (Emphasis added.)	[No definition useful life is gi en in the app cable regul tions.]
PP. 7-8: "Similarly, it is submitted that *salvage value,* as that term is used in the Treasury Regulations interpreting Section 23(1), *means the amount (determined at the time of acquisition) which it is reasonable to estimate will be realizable upon the sale or other disposal of the asset when it is no longer useful in a taxpayer's business and is retired from service.*" (Emphasis added.) [This language is repeated in substantially identical manner at pages 18-19 of the Commissioner's brief.]	Reg. Sec. 1.167(a)-1(c) [in part]: *"Salvage value is the amount (determined at the time of acquisition) which is estimated will be realizable upon sale or other disposition of an asset when it is no longer useful in the taxpayer's trade or business or in the production of his income and is to be retired from service by the taxpayer."*	[No definition salvage value given in the a plicable regul tions.]

With nothing in the applicable regulations, rulings or decisions to sustain the Commissioner's present claims as to the meanings of useful life and salvage value, it is understandable that he would like this case to be decided on the basis of his newly evolved concepts in the 1956 regulations, which, of course, cannot control determination of the issues at bar.

(5) The authorities relied on by the Commissioner do not support his contentions herein.

The cases cited by the Commissioner at page 28 of his brief neither support his conclusions nor assist in the determination of the issues here involved.

Burlington Gazette Co. v. *Commissioner of Internal Revenue,* 75 F. 2d 577 (C.C.A. 8th, 1935), stands for the proposition that annual depreciation deductions may not aggregate more than the cost of the asset. We do not dispute this.

Cameron v. *Commissioner of Internal Revenue,* 56 F. 2d 1021 (C.C.A. 3rd, 1932), decided the status of a partnership in connection with allowance of a new rate for the depreciation of partnership assets, and also determined the value of depreciable property on March 1, 1913. Neither point is relevant here.

Becker v. *Anheuser-Busch, Inc.,* 120 F. 2d 403 (C.C.A. 8th, 1941), concerned a special argument on the alleged obsolescence of beverage bottles and cases incident to the onset of National Prohibition. These bottles and cases, held the court, would produce a loss for tax purposes only upon final disposition (120 F. 2d, at 418). We have no concern with National Prohibition or with bottles, obsolete or otherwise, herein.

With respect to *Cohn* v. *United States,* 57-1 USTC Para. 9457 (D.C.W.D. Tenn., 1957), (now on appeal to the Court of Appeals for the Sixth Circuit), it is a far cry from the specific target date of December 31, 1944 fixed by the Air Corps for the retirement of assets in that case to the numerous imponderables facing petitioner in this case and discussed in our opening brief at pages 4 and 26.

Throughout his brief the Commissioner repeatedly refers to the proposition that a reasonable allowance for depreciation depends upon the peculiar facts of each case, and cites the following cases as support for this proposition: *Pittsburgh Hotels Co.* v. *Commissioner of Internal Revenue,* 43 F. 2d 345 (C.C.A. 3rd, 1930); *Washburn Wire Co.* v. *Commissioner of Internal Revenue,* 67 F. 2d 658 (C.C.A. 1st, 1933); and *Geuder, Paeschke & Frey Co.* v. *Commissioner of Internal Revenue,* 41 F. 2d 308 (C.C.A. 7th, 1930). An examination of these cases discloses that they all involved *physical factors influencing the duration of the inherent economic usefulness* of the depreciable assets in question—not factors influencing the taxpayers' probable holding periods of the assets.

In the *Pittsburgh Hotels* case, these factors were the constant use of hotel property, out-dated construction and the extraordinarily dirty, corrosive air of Pittsburgh. In the *Geuder, Paeschke & Frey* case, an extraordinary repair and parts replacement policy prolonged the lives of the machines. In the *Washburn Wire* case, the court rejected the Commissioner's contention that the taxpayer's machines were not subject to depreciation after 1921 because the taxpayer (by taking 5% depreciation during 1912, 1913 and 1914 and 10% for the succeeding seven years) had implicdly given them a ten-year useful life and the ten years ended in 1921. The court allowed further depreciation because "The machinery was not worn out, nor had full depreciation ever been taken on it.'' (67 F. 2d, at 661.)

On page 16 of the Commissioner's brief, he cites *Terminal Realty Corporation,* 32 BTA 623 (1935), with specific reference to page 629. We call the Court's attention to this statement by the Board of Tax Appeals on that page:

> ''Deductions for depreciation are allowed for the purpose of restoring the cost of exhausting property over the period of its use from untaxed earnings derived from its use. The annual allowance is made pursuant to some plan for distributing the total cost of the plant over the period of its usefulness. *It is to be 'a reasonable allowance' with relation to the whole life period of the asset and need not be an exact measure of the actual wearing out of the property in the particular year. Under the 'straight line' method it may be assumed that depreciation proceeds at some average rate based upon an estimate of the number of years that the property will probably last.*'' (32 BTA, at 629; emphasis added.)

The Board's references to ''the *whole life period of the asset,*'' ''the *actual wearing out* of the property'' and ''the number of years that the property will probably *last*'' reveal depreciation as a process of physical exhaustion of the asset and useful life as the entire period of the asset's economic usefulness.

The Commissioner's treatment of two cases which we cited in our opening brief requires a few words.

With regard to the Commissioner's comment, at pages 32-33 of his brief, on *Massey Motors, Inc.* v. *United States,* 156 F. Supp. 516 (D.C.S.D. Fla., 1957), this Court will, of course, form its own conclusion as to whether the opinion on the depreciation issue in that case is erroneous. We fail to see, however, that the *Massey* case is in conflict with *Goldberg* v. *Commissioner of Internal Revenue,* 239 F. 2d 316 (C.A. 5th, 1956), as contended at pages 32-33 of the Commissioner's brief. Not only are the facts in the *Goldberg* case far removed from those in the *Massey* case and in the instant appeal, but the only real depreciation point considered by the Tax Court or by the Court of Appeals had to do with salvage value. This was set up at an arbitrary figure, under the *Cohan* rule.

At page 32 of the Commissioner's brief, the Commissioner's representatives contend that *Pilot Freight Carriers, Inc.,* 15 TCM 1027 (1956) (discussed at pages 23-24 of our opening brief), is not relevant to the issues at bar. We submit that the Commissioner's attitude in this case is inconsistent with his claims in that one. There existed in the *Pilot Freight Carriers* case the very "pattern of use of property for a given period and resale at a substantial price at the end of that period" emphasized in the Commissioner's brief at page 15. Despite this, not only did the Commissioner fail to contend in *Pilot Freight Carriers* that the useful life was equal to the holding period, but he actually claimed that the useful life was considerably *in excess* of the holding period.

Burnet v. *Niagara Falls Brewing Co.,* 282 U.S. 648 (1931), and *Gambrinus Brewery Co.* v. *Anderson,* 282 U.S. 638 (1931), cited at various places in the Commissioner's brief, concerned computation of a deduction for obsolescence—a factor which, as we have shown, is not involved in the instant case.

With respect to *Anne P. Humphrey,* 5 TCM 21 (1946), aff'd 162 F. 2d 853 (C.A. 5th, 1947), cert. den. 332 U.S. 817, cited at pages 35, 38 and 47 of the Commissioner's brief, the opinion reveals that there was no contest on the salvage value point, and that the actual holding on the depreciation issue was simply a standard application of the rule laid down in *Virginian Hotel Corporation* v. *Helvering,* 319 U.S. 523 (1943).

In *W. H. Norris Lumber Co., Inc.,* 7 TCM 728 (1948), and *L. A. Davidson,* 12 TCM 1080 (1953), discussed at pages 39-40 of the Commissioner's brief, the court speaks of salvage value determined at the end of useful life defined as petitioner contends, not at the end of the taxpayer's holding period.

With regard to *The Bolta Company,* 4 TCM 1067 (1945), cited at pages 36, 40, 42 and 47 of the Commissioner's brief, the machines in question deteriorated *physically* during a five-year period so as to be *physically* unusable for their basic purpose at the end of that time. The salvage value determined was the value at the end of this period of physical usefulness. The analogous period in the present case is four years.

It is surprising that the Commissioner cites *Commissioner of Internal Revenue* v. *Mutual Fertilizer Co.,* 159 F. 2d 470 (C.C.A. 5th, 1947) (pages 17 and 42 of his brief). In that case, the court outlawed precisely the type of hindsight determination of useful life which the Commissioner is trying to impose in the case at bar.

At least one case cited in the Commissioner's brief directly supports petitioner's contention that salvage value, for depreciation purposes, is junk or scrap value. The Commissioner would have this Court come to an erroneous understanding of the holding in *W. Horace Williams Company, Inc.* v. *Lambert,* 56-2 USTC Para. 9839 (D.C.E.D. La., 1956). The Commissioner's brief states:

> "In that case the salvage value of a particular asset [the barge *Cap,* a converted LST], in 1948 and 1949, was $50,000. In 1950, the tax year in question, the

salvage value fluctuated from zero to $30,000. The court found that an estimated value of $30,000 was fair and reasonable and the depreciation allowance for 1950 was adjusted accordingly.'' (Pages 46-47, footnote 27, Commissioner's brief.)

The Commissioner's truncated version of the court's holding in the *Williams Company* case could well produce the impression that the case does not support petitioner's theory of salvage value. Actually, it fully supports petitioner. Finding of Fact No. 29 in that case reads, *in full*:

> ''The salvage value of the Barge *Cap* at various times during 1950 ranged from zero to $30,000, *fluctuating with the price of and demand for scrap.*'' (Emphasis added.)

We do not believe we need say anything further about that decision.

(6) The Commissioner's brief fails to answer the reasoning implicit in the authorities cited by petitioner.

The proposition that each case turns on its own particular facts is a cliche' that sets the stage for a denial of the relevance of the authorities cited by one's opponent. Thus, on pages 30 and 31 of the Commissioner's brief, he acknowledges our citation of *Sanford Cotton Mills,* 14 BTA 1210 (1929), Acq. X-2 CB 63, *Merkle Broom Co.,* 3 BTA 1084 (1926), Acq. V-2 CB 2, *Max Kurtz, et al.,* 8 BTA 679 (1927), Acq. VII-1 CB 18, *General Securities Co.,* BTA Memo, CCH Dec. 12,500-D (1942), aff'd 137 F. 2d 201 (C. C.A. 6th, 1943), and states that ''Since each of the cases turns on its own particular facts, they do not establish a binding precedent for this case.''

The Commissioner's brief then proceeds (page 31) with the erroneous observation that in each of these cases ''the usual company car or truck situation was involved.''

Rather, the reason petitioner cited these cases is that they involved fact situations where the taxpayer disposed of his cars (at substantial prices, too, it was noted in the *General Securities* case) before the general business life of the cars was exhausted. Nevertheless, in each reported instance where such a "particular" factual situation obtained, the Commissioner contended and the court invariably held that the useful life of the cars was coterminous with their general business life and was *not* equivalent to the shorter holding period of the taxpayer.

This principle does not lead to "one rigid formula," as asserted by the Commissioner at page 20 of his brief. We were careful to point out in our opening brief (page 12) that

> "It has long been recognized that the particular operating practice of a taxpayer has important effects on the physical life of an asset. Thus the particular use may shorten the total period of economic usefulness materially—usually through abnormally heavy operation or undermaintenance. To the extent that such operating practice is proved, a particular taxpayer is permitted to adjust his depreciation rate accordingly."

This well-established principle represents a faithful recognition of, and allowance for, the "variables" referred to by the Supreme Court of the United States in *Detroit Edison Company* v. *Commissioner of Internal Revenue,* 319 U.S. 98 (1943).

The "particular fact" of the instant case is that petitioner's holding period for cars, in the taxable years under review, fell short of the useful life of the cars. The cases cited in our opening brief (pages 17-21) and the instant case display the same facts as to useful life. Thus, the cited cases are useful precedents in this case. They indicate to this Court what courts have found the rule to be in the past—namely, that useful life means the inherent business life of the asset, not the period the particular taxpayer happened to hold the asset.

The Commissioner's failure to explain away his rulings which we cited in our opening brief is equally significant. At page 26 of his brief, he seeks to avoid the impact of O.D. 845, C.B. January-June 1921, page 178 (cited in our opening brief at page 14), by stating:

> "The general proposition quoted from O.D. 845, 4 Cum. Bull. 178 (1921), supports the Tax Court's opinion. [Just how it does this is not indicated.] In reading the office decision, taxpayer overlooks the fact that his cars were acquired for rental-car purposes and have a short useful life in that business."

Obviously, the latter sentence is a good argument only if the Commissioner's definition of "useful life" be assumed!

In the same vein is the Commissioner's discussion of Rev. Rul. 108, 1953-1 CB 185, and Rev. Rul. 54-229, 1954-1 CB 124, at page 27 of his brief. Those rulings concerned the question whether profit upon sale of leased and rented automobiles was taxable at ordinary or capital gains rates. The Commissioner knew (and stated in Rev. Rul. 108) that depreciation was allowable on such automobiles. Since each dollar of depreciation deducted reduced the income tax basis of the automobiles, correspondingly each dollar so deducted increased the profit, for income tax purposes, upon sale. The automobiles which were the subject of those rulings were held for periods of approximately a year or less. If the Commissioner's rationale of useful life in this appeal were correct, why did he not, in those rulings, state that the holding period of those automobiles was their useful life, that the selling price was their salvage value, and that, therefore, there was no capital gain? Instead, the Commissioner went out of his way to say that the automobiles were sold after having been leased "for periods *substantially less* than their normal useful life." (Emphasis added.)

We repeat: Would the Commissioner contend that his published rulings are loosely drawn, with little or no regard to the language used?

The final comment of the Commissioner (page 31 of his brief) on the cases cited at pages 17-21 of our opening brief, is that the findings in those cases were reasonable, while the use of a four-year life in our case is not. As we indicated in our opening brief, we believe that the Commissioner has used as his index of reasonableness the presence of capital gains upon disposition of the cars. The above-mentioned cases are silent as to gains, if any, upon the sales of the cars by the taxpayers concerned, thus indicating that these courts regarded that point as immaterial. Nevertheless, these cases all involved years well before passage of the Revenue Act of 1942 and the enactment of what became known as Section 117(j) of the 1939 Code. Any gain realized on the sale of depreciable business assets before 1942 was fully taxable at ordinary rates. Is it the Commissioner's position that depreciation methods which were reasonable before 1942 became unreasonable after 1942, without any change in the depreciation statute? May we refer the Court to our discussion (appearing at pages 31-36 of our opening brief) of what we believe to be the Commissioner's real motivations in this field.

(7) The Commissioner's position on "useful life" and "salvage value" under the 1939 Code has been correctly and decisively rejected in recent decisions by the United States District Courts.

The Commissioner's position on the meaning of "useful life" under the 1939 Code has just been thoroughly considered and completely rejected by the United States District Court for the District of Delaware in a decision handed down after submission of petitioner's opening brief herein. This decision is *The Hertz Corporation* (*successor by merger to J. Frank Connor, Inc.*) v. *United States of America,* Civil Action No. 1921, July 17, 1958 (reported at 58-2 USTC Para. 9720).

Although that case involves accelerated depreciation under the 1954 Code, it is a directly applicable authority in the instant case so far as the meaning of useful life is concerned. It should be noted that the business and facts involved in the *Hertz* case are substantially identical to those in the present case.

In the *Hertz* case, as here, the Government insisted that useful life, for depreciation purposes, was the holding period of the particular taxpayer involved. However, for periods prior to issuance of the Commissioner's new depreciation regulations in 1956, the District Court rejected the Government's claim and upheld the taxpayer's contention that useful life meant physical life.

The Court stated:

> "Over the years, 'useful life' has come to be regarded in the field of business and accounting to mean the business life of an asset regardless of whether it passed from one owner to another. *Useful life was meant to be the total life for which the asset was useful for business purposes.* Not only was this the general accounting understanding of the concept of useful life,

but the uncontradicted testimony of expert certified public accountants was that prior to the promulgation by the Commissioner of Internal Revenue of his 1956 regulations on depreciation, their experience with representatives of the Internal Revenue Service was always that the depreciation rate was computed on the basis of the aggregate business life, regardless of changes in the ownership of the asset. . . .

" . . . Insofar as concerns the Revenue Laws, these two terms [useful life and salvage value] had their origin in the attempts by the Department of Internal Revenue and the Courts to set up a proper standard for the deduction of a reasonable allowance for depreciation. . . .

"But neither the Congress nor the Department gave an official definition of 'useful life' and 'salvage value.' Consequently, like Topsy, their meaning just 'growed'. *Based upon accepted accounting principles, 'useful life' came to mean the period over which the particular piece of property was capable of performing the task for which it was created. In other words, it was the whole physical life of the asset, not just in the hands of a particular taxpayer, which determined its 'useful life'. And, over the years, 'salvage value' became generally defined as scrap value, or the remainder left in the asset when it was worn out. . . .*

" . . . The Department joins issue raising the first question for disposition, namely, does useful life mean the life of the asset as long as it is used by the taxpayer or its whole life?

"The Commissioner's argument is based in the main upon three grounds. First, he says that the tax laws for many years have permitted a 'reasonable allowance' for depreciation, as a result of which the Department is vested with broad authority to promulgate regulations governing the taking of depreciation. Secondly, he contends that the term 'useful life' is but one of the elements of depreciation and means, not the whole physical life of the asset, but its useful life in the taxpayer's business. . . . Thirdly, he says that to construe the phrase 'useful life' as the whole physical life of the asset would have the effect of distorting the long-settled concept of depreciation which, insofar as concerns the tax laws, has meant from its inception a reasonable allowance, or sum, which should be set aside annually in order that at the end of the useful life of the asset, the aggregate of the sums set aside will, together with salvage value, equal its original cost. *Detroit Edison Co.* v. *Commissioner,* 319 U.S. 98. To construe 'useful life' as the whole physical life of the asset, the Commissioner argues, permits taxpayers in businesses having a rapid turnover of assets to sell a comparatively new asset at a relatively high price and treat the difference between the sale price and junk salvage value as capital gains rather than income, resulting in a tax avoidance scheme of some magnitude. . . .

"But the Commissioner's argument glosses over . . important aspects of this case. *First, regardless of their original meaning, by* 1954 *'useful life' meant the whole physical life of the asset. . . .*

"I accept the testimony of accountants from nationally recognized firms that *by* 1954, *the phrase 'useful life' was taken in business and accounting circles to mean the whole physical life of the asset and that the useful life of an automobile used in a business was four years.* Their testimony was virtually unchallenged on cross-examination and the Commissioner offered no testimony in his own behalf. . . .

" . . . For years, the Treasury Department's Bulletin F (Rev. Jan. 1942) defining the Department's general depreciation policy and tables of estimated lives of certain assets has used this language:

> 'The Federal income tax in general is based upon net income of a specified period designated as the taxable year. The production of net income usually involves the use of capital assets which wear out, become exhausted, or are exhausted, or are

> consumed in such use. The wearing out, exhaustion, or consumption usually is gradual, extending over a period of years. *It is ordinarily called depreciation, and the period over which it extends is the normal useful life of the asset.'* (Emphasis added.)

This bulletin goes on to recommend to taxpayers that for depreciation purposes, they assign a three year life to business cars and a five year life to pleasure cars. In Rev. Rul. 108, 1953-1 C.B. 185, the Commissioner referred to the practice of selling automobiles after 'leasing them for substantially less than their normal useful lives.' Compare also Rev. Rul. 54-229, 1954-1 C.B. 124, which uses substantially this same language.
. . .

"All of this fairly confirms the testimony of the accountants that the Commissioner, himself, in the great majority of cases was interpreting 'useful life' as the whole useful life of the asset and accepting the useful life of an automobile used in a business as four years.

"The attitude of the Courts with reference to the meaning of 'useful life' prior to the passage by Congress of the 1954 Code is a proper subject for consideration here. In the following cases, the Board of Tax Appeals conceded a four year useful life to the business automobiles of the taxpayer despite its practice of disposing of them in less than three years. *Re Sanford Cotton Mills,* 14 BTA 1210 (1929); *Re Merkle Broom Co.,* 3 BTA 1084 (1926); *Re Max Kurtz et al.,* 8 BTA 679 (1927).

"In *General Securities Co.,* BTA Memo, CCH Dec. 12,500-D (1942), aff'd 137 F. 2d 201 (C.C.A. 6th, 1943), the Board said this:

> 'In its business petitioner used one or two automobiles in which its agents traveled over territory located in all of the southern states. Each automobile traveled some 60,000 to 75,000 miles a year.

Petitioner kept his automobiles from one to two years. When petitioner traded its cars in after one year, from a value standpoint, they had a third to a half of their original value left. The normal useful life of automobiles used by petitioner in its business was three years.' (BTA Memo, CCH Dec. 12,500-D, at 37,941.)

"*Pilot Freight Carriers, Inc.,* 15 TCM 1027 (1956) and *Massey Motors, Inc.* v. *United States,* 156 F. Supp. 516 (D.C.S.D. Fla. (1957)) are recent decisions of lower Courts reaching the same result. In the brief of the Commissioner in *Philber Equipment Corporation* v. *Commissioner,* 237 F. 2d 129 (3rd C. 1956), this significant language is used by counsel for the Government:

> 'Because of existing conditions [taxpayer] knew when it purchased equipment that it would likely be able to rent such equipment only for a period that was *substantially less than its useful life.'* (Emphasis added.)

Other cases illustrate the same distinction between useful life of an asset in the business and its whole, physical life: *West Virginia & Pennsylvania Coal & Coke Co.,* 1 BTA 790 (1925); *W. N. Foster, et al.,* 2 TCM 595 (1943); *Nat Lewis,* 13 TCM 1167 (1954). *It is safe to say that prior to the passage of the* 1954 *Act, a fairly steady line of lower court decisions had emerged recognizing 'useful life' as a word of art meaning the whole physical life of the asset. . . .* " (Emphasis added.)

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The District Court's opinion is significant in this appeal not only for its analysis of the term "useful life", but for its references to the Tax Court's opinion below:

"Except for *Evans* v. *Commissioner of Internal Revenue,* 16 CCH Tax Ct. Mem. 156 (July 31, 1957), where the Tax Court held for the Government in respect to the salvage value question *without, however, assigning any reasons for its conclusions,* this case is one of first instance.'' (Emphasis added.)

" . . .

''The Commissioner relies chiefly on the decision of the Tax Court in Robley H. Evans, elsewhere cited, where the Court held that a salvage value based upon the estimated proceeds of the disposition of the asset at the end of its useful life in the taxpayer's hand should be taken into consideration. *The force of the decision is blunted because it gives no reasons for the result.''* (Emphasis added.)

In addition, very recent decisions of the United States District Court for the Southern District of Florida confirm in all respects the petitioner's views of useful life and salvage value.

In *Davidson* v. *Tomlinson,* Civil Action No. 3609, decided July 23, 1958 (reported at 58-2 USTC Para. 9739), the facts, virtually identical to those at bar, were as follows:

The taxpayer, a partnership known as U-Drive Autos (whose name was later changed to National Car Rentals), was engaged during the taxable years 1950, 1951, 1952 and 1953 in leasing and renting automobiles and trucks on a daily, weekly, monthly or yearly basis.

The taxpayer purchased cars and trucks only as it had need to fulfill the requirements of its business, and, particularly, on the basis of the coming and going of the winter tourist season.

The taxpayer kept most of its cars in service for approximately one year, although some were kept longer and some were kept less than that period of time. Vehicles were sold for substantial amounts when taxpayer decided to dispose of them.

The Court held:

> "National Car Rentals depreciated its rental cars and trucks (other than Patrol cars) on the straight line method, utilizing an estimated useful life of three years with a $50.00 salvage value. The cars leased to the Duval County Road Patrol [on an annual basis] were depreciated on an estimated useful life of 24 months. The Court finds these methods and rates to be reasonable and fair."

Further, in a companion case decided the same day, *Lynch-Davidson Motors, Inc.* v. *Tomlinson,* Civil Action No. 3610 (reported at 58-2 USTC Para. 9738), the taxpayer, an automobile and truck dealership, used a three-year useful life, with $50 salvage value, in depreciating company cars (which term, the court noted, it was using to include trucks). The taxpayer "followed the practice of disposing of the company cars when the new models were brought out by the manufacturer." During the taxable year under review (the fiscal year ended May 31, 1949), the taxpayer sold a total of 17 company cars, nine of which were held more than six months and eight of which were held less than six months. It is noteworthy that of the nine held for more than six months the *profit alone* was $2,388.60, indicating sales prices of substantial amounts.

The court held:

> "The plaintiff is entitled to the depreciation claimed on its company cars as shown by its corporate income tax return [three-year useful life with $50 salvage value]. . . ."

CONCLUSION.

We have cited many authorities (including decisions expressly acquiesced in by the Commissioner and rulings which he himself issued) to sustain the proposition that the long-accepted meaning of "useful life" is the physical or functional life of the asset. That life is reasonably determinable. The taxpayer's intentions for the disposition of the asset some years in the future are never reasonably determinable today.

The Commissioner has not presented a single authority to sustain his definition of "useful life". Since "salvage value" is the residual value at the end of "useful life," the Commissioner's failure to support his definition of "useful life" carries with it a corresponding failure to support his definition of "salvage value."

The analysis in our first brief has been fully confirmed by the three recent decisions of the United States District Courts in Delaware and Florida, two of them involving the very business under review in the case at bar.

For the reasons set forth in our briefs, we respectfully submit that the Tax Court's conclusions herein with respect to allowable automobile depreciation during 1950 and 1951 should be reversed, and that the depreciation allowance claimed in petitioner's returns for those years should be sustained.

Roswell Magill
15 Broad Street
New York, New York

Lyle L. Iversen
800 Hoge Building
Seattle, Washington

Edgar Bernhard
33 North LaSalle Street
Chicago, Illinois

Donald J. Yellon
33 North LaSalle Street
Chicago, Illinois

John C. Klett, Jr.
15 Broad Street
New York, New York
Attorneys for Petitioners

Of Counsel:
Cravath, Swaine & Moore
15 Broad Street
New York, New York

D'Ancona, Pflaum, Wyatt & Riskind
33 North LaSalle Street
Chicago, Illinois